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FEDERAL RESERVE SYSTEM

12 CFR Chapter II

[Docket No. R-1539]

RIN 7100 AE 53

Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is inviting comment on an advance notice of proposed rulemaking (ANPR) regarding approaches to regulatory capital requirements for depository institution holding companies significantly engaged in insurance activities (insurance depository institution holding companies), and nonbank financial companies that the Financial Stability Oversight Council (FSOC or Council) has determined will be supervised by the Board and that have significant insurance activities (systemically important insurance companies). The Board is inviting comment on two approaches to consolidated capital requirements for these institutions: an approach that uses existing legal entity capital requirements as building blocks for insurance depository institution holding companies and a simple consolidated approach for systemically important insurance companies.

DATES: Comments must be received no later than August 17, 2016.

ADDRESSES: You may submit comments, identified by Docket No. R-1539; RIN 7100 AE 53), by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- Email: regs.comments@federalreserve.gov. Include Docket No. R-1539; RIN 7100 AE 53) in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room 3515, 1801 K Street, NW (between 18th and 19th Streets NW), Washington, DC 20006 between 9:00 a.m. and 5:00 p.m. on weekdays. For security reasons, the Board requires that visitors make an appointment to inspect comments. You may do so by calling (202) 452-3684. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

FOR FURTHER INFORMATION CONTACT: Thomas Sullivan, Associate Director, (202) 475-7656, Linda Duzick, Manager, (202) 728-5881, or Suyash Paliwal, Senior Insurance Policy Analyst, (202) 974-7033, Division of Banking Supervision and

Regulation; or Laurie Schaffer, Associate General Counsel, (202) 452-2272, Benjamin W. McDonough, Special Counsel, (202) 452-2036; Tate Wilson, Counsel, (202) 452-369; David Alexander, Counsel, (202) 452- 2877; or Mary Watkins, Attorney (202) 452-3722, Legal Division.

SUPPLEMENTARY INFORMATION:

I. Introduction

A. Background

Robust capital is an important safeguard to protect the safety and soundness of financial institutions; enhance the resilience of financial institutions to position them to better navigate periods of financial or economic stress; and mitigate threats to financial stability that might be posed by the activities, material financial distress, or failure of financial institutions. To help achieve these benefits, various provisions of Federal law require the Board and other Federal banking agencies to establish minimum capital standards for holding companies that own insured depository institutions (IDIs) and for financial firms that are designated by the FSOC for supervision by the Board. The capital standards developed by the Board take into account the overall risk profile and the size, scope, and complexity of the operations of the institution. Further, the law allows the Board to tailor the minimum capital requirements applicable to companies that both own an IDI and significantly engage in insurance activities as well as for systemically important insurance companies.

The Board's supervisory objectives in setting capital requirements for the consolidated institution focus on the safety and soundness of the company and its IDI and on enhancing financial stability, and complement the primary mission of state legal entity

insurance supervisors, which tends to focus on the protection of policyholders.¹ To achieve these objectives, the Board seeks comment on several approaches to designing a regulatory capital framework for supervised institutions significantly engaged in insurance activities that is intended to ensure that the institution has sufficient capital, commensurate with its overall institution-wide risk profile (1) to absorb losses and continue operations as a going concern throughout times of economic, financial, and insurance-related stress (e.g., morbidity, mortality, longevity, natural and man-made catastrophes); (2) to serve as a source of strength to any subsidiary depository institutions;² and (3) to substantially mitigate any threats to financial stability that the institution might pose.

B. The Board’s Consolidated Supervision of Systemically Important Insurance Companies and Insurance Depository Institution Holding Companies

This ANPR seeks comment on proposed approaches to regulatory capital requirements that are tailored to the risks of supervised insurance institutions, including both insurance depository institution holding companies and systemically important insurance companies.

¹ For discussion regarding state supervision of insurance, see, e.g., Financial Stability Oversight Council, Basis of the Financial Stability Oversight Council’s Final Determination Regarding American International Group, Inc. (July 8, 2013), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf>; Financial Stability Oversight Council, Basis of the Financial Stability Oversight Council’s Final Determination Regarding Prudential Financial, Inc. (Sept. 19, 2013), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf>.

² 12 U.S.C. 1831o–1. See also, 12 U.S.C. 1844 and Section 706, Division O, of the Consolidated Appropriations Act, 2016, Public Law 114-113, 129 Stat. 2242 (2015).

The Board has broad authority to establish regulatory capital standards for savings and loan holding companies (SLHCs) and bank holding companies (BHCs)³ under the Home Owners' Loan Act (HOLA) and Bank Holding Company Act, respectively.⁴ The Board's supervisory objectives for insurance depository institution holding companies include ensuring the safe and sound operation of the consolidated firms and subsidiary IDIs, and ensuring that holding companies can serve as a source of strength for any subsidiary IDIs.⁵ In addition, certain nonbank financial companies with significant insurance activities have been designated by the Council pursuant to section 113 of the Dodd-Frank Act⁶ to be supervised by the Board and made subject to enhanced prudential standards. For these systemically important insurance companies, the Board is required under section 165 of the Dodd-Frank Act to establish enhanced prudential standards, including more stringent risk-based and leverage capital requirements, as well as stress tests.⁷

³ BHCs that are financial holding companies may engage in insurance underwriting activities. 12 U.S.C. 1844(k).

⁴ 12 U.S.C. 1841 et seq; 12 U.S.C. 1467a(g).

⁵ 12 U.S.C. 1831o–1. See also 12 U.S.C. 1467a(g)(5).

⁶ 12 U.S.C. 5323; see also Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc. (July 8, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf>; Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. (Sept. 19, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf>.

⁷ 12 U.S.C. 5365. Section 165 of the Dodd-Frank Act would also direct the Board to establish consolidated capital requirements and administer stress test for any insurance depository institution holding companies that are BHCs with at least \$50 billion in total consolidated assets. Presently, there are no BHCs that are also insurance depository institution holding companies.

With respect to both insurance depository institution holding companies and systemically important insurance companies, the Board must establish minimum leverage capital requirements and minimum risk-based capital requirements that apply (1) on a consolidated basis, and (2) are at least as stringent as the generally applicable capital requirements that applied to IDIs at the time the Dodd-Frank Act was adopted, as well as current generally applicable IDI capital requirements.⁸ The Dodd-Frank Act has been amended to allow the Board to tailor these minimum capital requirements as they would apply to persons regulated by state or foreign insurance regulators.⁹

The Board currently supervises twelve insurance depository institution holding companies and two systemically important insurance companies. Collectively, these firms have approximately \$2 trillion in assets and represent approximately one-quarter of the assets of the U.S. insurance industry. These institutions range in size from approximately \$3 billion in total assets to about \$700 billion in total assets, and engage in a wide variety of insurance and non-insurance activities. Some of the firms operate exclusively in the United States, and some have material international operations. These institutions have a variety of ownership structures, including stock and mutual forms of ownership. Some of these institutions prepare financial statements according to U.S. Generally Accepted Accounting Principles (U.S. GAAP), and some do not, preparing financial statements only according to U.S. Statutory Accounting Principles (SAP) filed with their relevant state insurance regulators. The insurance depository institution holding companies tend to have simpler structures, often have an operating company,

⁸ 12 U.S.C. 5371.

⁹ 12 U.S.C. 5371(c)(1).

rather than a holding company, as the top-tier parent, and have a relatively greater U.S. focus in their operations. By contrast, the systemically important insurance companies are relatively larger financial institutions with substantial international operations, comparatively complex organizational structures relative to other insurance companies, and non-insurance as well as insurance activities.

The Board aims to develop regulatory capital frameworks for insurance depository institution holding companies and systemically important insurance companies that are consistent with the Board's supervisory objectives and appropriately tailored to the business of insurance. The Board is seeking comment on different frameworks that could be applied to insurance depository institution holding companies and systemically important insurance companies. As described below, this ANPR outlines two conceptual frameworks, one of which may be more appropriate for large, complex, systemically important institutions, while the other may be more appropriate for generally less complex firms such as the current population of insurance depository institution holding companies.

The Board is also seeking comment on the criteria that should be used to determine which supervised institutions are subject to regulatory capital requirements that are tailored to the business of insurance. A supervised insurance institution could become subject to tailored regulatory capital rules based on the significance of these activities for the consolidated firm. The Board could apply a threshold based on a percentage of total consolidated assets attributable to insurance activities. For example, for purposes of determining whether an SLHC is significantly engaged in insurance activities and should be subject to capital requirements that are tailored to these risks, the

Board is considering using the threshold in the Board's existing capital requirements (Regulation Q).¹⁰ Under this approach, an SLHC would be subject to the capital requirements as an insurance SLHC if it held 25 percent or more of its total consolidated assets in insurance underwriting subsidiaries (other than assets associated with insurance underwriting for credit risk).¹¹ Further, the Board could define systemically important insurance companies as FSOC-designated nonbank financial companies with at least 40 percent of total consolidated assets related to insurance activities (as of the end of either of the two most recently completed fiscal years), or as otherwise ordered by the Board. These thresholds could reflect a level of insurance activity that is significant rather than incidental to the institution's activities.

The Board invites comment on all aspects of these frameworks, including whether these frameworks are workable, would enhance the resilience of these institutions, and would reduce risks to financial stability. The Board also invites comment and suggestions on other frameworks that may better achieve these purposes. In addition, the Board invites comment on the costs and benefits of these and alternate approaches, and on the various advantages and difficulties of each approach. To help the Board address specific issues raised by the regulatory capital frameworks discussed below, the Board also invites comment on the specific questions listed throughout this notice.

¹⁰ 12 CFR 217.2.

¹¹ 12 CFR 217.2. Depository institution holding companies comprise BHCs as well as SLHCs. Presently, the population of Board-supervised insurance depository institution holding companies includes 12 SLHCs significantly engaged in insurance activities. To the extent that a BHC met the definition of an insurance depository institution holding company, the Board would need to consider whether to exclude the BHC from the Board's Regulation Q and instead apply a different approach.

II. Consolidated Capital Frameworks for Supervised Institutions Significantly Engaged in Insurance Activities: Two Options

In developing and evaluating potential capital frameworks, the Board relied on its experience in supervision of financial firms and with the development and application of capital standards through normal and stressed periods; discussions with affected financial firms, including firms engaged in insurance activities; the purposes of and requirements in Federal law; and information and insights provided by other supervisors, including state insurance supervisors, among other things.

Insurance supervisors, insurance companies and others have argued that because liability structures, asset classes, and asset-liability matching of insurance companies differ markedly from those of a typical BHC, the capital framework (or frameworks) should be tailored to the business mix and risk profile of insurance depository institution holding companies and systemically important insurance companies. They have also contended that leverage limits based on the ratio of equity to total assets, which are an important backstop in a banking regulatory capital framework, may have less value as a risk metric for supervised institutions significantly engaged in insurance activities because they do not address the different liability structure that is inherent to the insurance business. The Board has flexibility to develop leverage and risk-based capital requirements that are tailored to appropriately reflect the risks of supervised institutions significantly engaged in insurance activities.¹²

At the same time, supervisors and commenters recognize that a capital framework also should take into account all material risk types (insurance and non-insurance) in

¹² See Insurance Capital Standards Clarification Act of 2014, Public Law 113-279, 128 Stat. 3017 (2014).

these institutions. Capital standards that do not account for all types of material risks tend to be ineffective and incent riskier activity. In addition, to the greatest extent possible, the capital framework should take account of risks across the entire firm – in the holding company, in regulated subsidiaries, and in unregulated subsidiaries. The financial crisis demonstrated that risks of financial distress often spread across an organization from unregulated subsidiaries to regulated subsidiaries.¹³ Moreover, the framework should be as standardized as possible, rather than relying predominantly on a firm’s internal capital models. Greater standardization will produce more consistent capital requirements, enhance comparability across firms, and promote greater transparency.¹⁴

The capital framework also should be based on U.S. regulatory and accounting standards and not foreign regulatory and accounting standards in order to best meet the needs of the U.S. financial system and insurance markets while reflecting the risks inherent in the business of insurance. The framework should strike a reasonable balance between simplicity and risk sensitivity. Achieving this balance will help ensure that risks are accurately captured while minimizing regulatory burden and increasing comparability and transparency across firms. The framework also should be executable in the short-to-medium term. Finally, the framework should contribute to the stability of the financial

¹³ For example, severe losses in non-insurance subsidiaries may undermine confidence in an entire insurance organization and contribute to a firm’s inability to meet obligations. Board of Governors of the Federal Reserve System, Regulatory Reform, American International Group (AIG), Maiden Lane II and III, available at https://www.federalreserve.gov/newsevents/reform_aig.htm.

¹⁴ Actuarial models, as opposed to asset risk-weighting models, are nonetheless important in setting insurance reserves.

system and should serve as a good basis for a supervisory stress test regime to the extent these provisions apply to the regulated firm.

The Board invites comment on the considerations that should guide the development of a regulatory capital framework for insurance depository institution holding companies and systemically important insurance companies.

Question 1. *Are these identified considerations appropriate? Are there other considerations the Board should incorporate in its evaluation of capital frameworks for supervised institutions significantly engaged in insurance activities?*

Question 2. *Should the same capital framework apply to all supervised insurance institutions?*

Question 3. *What criteria should the Board use to determine whether a supervised insurance institution should be subject to regulatory capital rules tailored to the business of insurance?*

Question 4. *If multiple capital frameworks are used, what criteria should be used to determine whether a supervised insurance institution should be subject to each framework?*

Question 5. *In addition to insurance underwriting activities, what other activities, if any, should be used to determine whether a supervised institution is significantly engaged in insurance activities and should be subject to regulatory capital requirements tailored to the business mix and risk profile of insurance?*

The remainder of this section will describe two potential regulatory capital frameworks for supervised institutions significantly engaged in insurance activities; discuss the strengths and weaknesses of each approach; and suggest ways in which each approach could be effectively applied. The Board invites comment on all aspects of each approach. The Board will then use these comments to develop a specific proposal, likely based on these two approaches, and invite public comment on that specific proposal.

A. Option 1: Building Block Approach

The Board has traditionally set capital requirements for holding companies on a consolidated basis.¹⁵ Among other things, a consolidated capital standard deters firms from placing assets in a particular legal entity, where the assets may be subject to lower, or no, capital requirements. Many SLHCs that are supervised insurance institutions because they own depository institutions do not produce consolidated financial statements.¹⁶ This presents potential challenges to the development of consolidated capital requirements that would not impose undue burden on these institutions.

One approach that would accommodate this would aggregate capital resources and capital requirements across the different legal entities in the group to calculate combined qualifying and required capital. A firm's aggregate capital requirements generally would be the sum of the capital requirements at each subsidiary. This is a building block approach (BBA). The capital requirement for each regulated insurance or depository institution subsidiary would be based on the regulatory capital rules of that subsidiary's functional regulator--whether a state or foreign insurance regulator for insurance subsidiaries or a federal banking regulator for IDIs. The BBA would then build upon and aggregate legal entity (insurance, non-insurance financial, non-financial, and holding company) qualifying capital and required capital, subject to adjustments.

¹⁵ See 12 CFR part 217.

¹⁶ Section 171(c)(3) of the Dodd-Frank Act, as amended, prohibits the Board from requiring, pursuant to the Dodd-Frank Act or HOLA, supervised institutions that only prepare financial statements in accordance with SAP to prepare financial statements in accordance with U.S. GAAP. 12 U.S.C. 5371(c)(3)(A)-(B).

Under this approach, the regulatory capital requirements for a regulated insurance underwriting firm would be determined by reference to the rules of the appropriate state or foreign insurance supervisor for the firm. The regulatory capital requirement for each IDI generally would be determined under the Board’s Regulation Q or under other capital rules applicable to IDIs.¹⁷ The regulatory capital requirement for any other regulated non-insurance or unregulated subsidiary legal entity, such as a mid-tier holding company, would also be determined under the Board’s Regulation Q.

As discussed further below, BBA may require the use of several types of adjustments in the calculation of a firm’s enterprise-wide capital requirement. Adjustments may be necessary to conform or standardize the accounting practices under SAP among U.S. jurisdictions, and between SAP and foreign jurisdictions. Similarly, adjustments may be necessary to eliminate inter-company transactions.

Additionally, the BBA may require consideration of cross-jurisdictional differences. As discussed below, this would be achieved through the use of scalars. Scalars may, for example, be appropriate to account for differences in stringency applied by different insurance supervisors, and to ensure adequate reflection of the safety and soundness and financial stability goals, as opposed to policyholder protection, that the Board is charged with achieving.

The ratio of aggregate qualifying capital to aggregate required capital would represent capital adequacy at a consolidated level. Represented in an equation, the BBA could be summarized as follows:

$$\text{Capital Ratio (BBA)} = \frac{\sum \text{Qualifying Capital}(i)}{\sum [\text{Adj. Required Capital}(i) \cdot \text{Scalar}(i)]}$$

¹⁷ 12 CFR part 217.

Question 6. *What are the advantages and disadvantages of applying the BBA to the businesses and risks of supervised institutions significantly engaged in insurance activities?*

Question 7. *What challenges and benefits do you foresee to the development, implementation, or application of the BBA? To what extent would the BBA utilize existing records, data requirements, and systems, and to what extent would the BBA require additional records, data, or systems? How readily could the BBA's calculations be performed across a supervised institution's subsidiaries and affiliates within and outside of the United States?*

Question 8. *What scalars and adjustments are appropriate to implement the BBA, and make the BBA effective in helping to ensure resiliency of the firm and comparability among firms, while minimizing regulatory burden and incentives and opportunity to evade the requirements?*

Question 9. *To what extent is the BBA prone to regulatory arbitrage?*

Question 10. *Which jurisdictions or capital regimes would pose the greatest challenges to inclusion in the BBA?*

Question 11. *How should the BBA apply to a supervised institution significantly engaged in insurance activity where the ultimate parent company is an insurer that is also regulated by a state insurance regulator? Are there other organizational structures that could present challenges?*

The key strengths of the BBA include the following: (1) it efficiently uses existing legal-entity-level regulatory capital frameworks; (2) it is an approach that could be developed and implemented expeditiously; (3) it would involve relatively low regulatory costs and burdens for the institutions; and (4) it would produce regulatory capital requirements that are tailored to the risks of each distinct jurisdiction and line of business of the institution.

The key weaknesses of the BBA include: (1) at the top-tier level, it is an aggregated, but not a consolidated, capital framework; (2) it would not discourage regulatory arbitrage within an institution due to inconsistencies across jurisdictional capital requirements and also may be vulnerable to gaming through techniques such as double leverage (*i.e.*, when an upstream entity issues debt to acquire an equity stake in a

downstream entity); (3) it would need to account for inter-company transactions, which may result in extensive adjustments; (4) it would require the Board to determine scalars regarding a large number of state and foreign insurance regulatory capital regimes; and (5) it likely would require legal-entity-level stress tests, presenting challenges to appropriate reflection of diversification and inter-company risk transfer mechanisms and other transactions.

The strengths of the BBA would appear to be maximized and its weakness minimized were the BBA to be applied to insurance depository institution holding companies, which generally are less complex, less international, and not systemically important. In this context, incremental safety and soundness benefits would appear to be complemented by the lower compliance costs due to the smaller number of scalars involved. In particular, the BBA is standardized, executable, applies U.S.-based accounting principles for U.S. legal entities, accounts for material insurance risks, strikes a balance between risk-sensitivity and simplicity, and is well-tailored to the business model and risks of insurance.¹⁸

For the systemically important insurance companies, the BBA may not capture the full set of risks these firms impose on the financial system without significant use of adjustments and scalars, thereby negating any potential burden reduction from the approach. These firms also tend to prepare financial statements under U.S. GAAP, thereby making a consolidated capital requirement less burdensome to compute. Accordingly, the BBA may not be appropriate for systemically important insurance companies.

¹⁸ In addition, the BBA could be implemented in a manner consistent with section 171(c)(3) of the Dodd-Frank Act.

The Board continues to analyze whether the BBA is appropriate as a regulatory capital framework and whether it may be appropriate for all insurance depository institution holding companies or only a subset of these firms. Specifically, the Board is considering whether larger or more complex insurance depository institution holding companies should be subject to a regulatory capital framework other than the BBA.

Question 12. *Is the BBA an appropriate framework for insurance depository institution holding companies? How effective is the BBA at achieving the goal of ensuring the safety and soundness of an insurance depository institution holding company?*

Question 13. *Would the BBA be appropriate for larger or more complex insurance companies that might in the future acquire a depository institution?*

Further, the Board seeks comment on the following key issues regarding the design and implementation of the BBA.

Baseline capital requirements at the legal-entity level. The BBA framework would begin with the baseline capital requirements at each legal entity. For example, for state-regulated insurance entities, the BBA could use different triggering thresholds from the state risk-based capital framework (e.g., the Company Action Level, the Authorized Control Level), or some other level as the appropriate baseline capital requirement. For some regulated foreign insurance entities, the Board would need to decide whether the local minimum capital requirement, prescribed capital requirement, or some other requirement is the appropriate baseline. For subsidiary IDIs, the BBA could use the minimum common equity tier 1, tier 1, or total risk-based capital requirements under the standardized approach in the Board's Regulation Q, as well as the tier 1 leverage ratio. For unregulated subsidiaries, the BBA could use the risk-based capital or leverage requirements for depository institutions or some other, similarly stringent approach.

Question 14. *In applying the BBA, what baseline capital requirement should the Board use for insurance entities, banking entities, and unregulated entities?*

State-by-state and international variances in accounting or capital treatment for supervised institutions significantly engaged in insurance activities. The accounting practices for insurance companies can vary from state to state due to permitted and prescribed practices, and can result in significant differences in financial statements between similar entities filing SAP financial statements in different states. Regulators both within and outside of the U.S. have the authority to take actions with respect to insurance companies that may result in variances from standard accounting practices. The BBA would need to address international or state regulator approved variances in accounting or capital requirements for regulated insurance entities.

Question 15. *How should the BBA account for international or state regulator approved variances to accounting rules?*

Question 16. *What are the challenges in using financial data under different accounting frameworks? What adjustments and/or eliminations should be made to ensure comparability when aggregating to an institution-wide level?*

Question 17. *What approaches or strategies could the Board use to calibrate the various capital regimes without needing to make adjustments to the underlying accounting?*

Inter-company transactions. Any approach to regulatory capital for a supervised institution significantly engaged in insurance activities that aggregates qualifying capital and required capital at different legal entities within the institution should address inter-company transactions. Although inter-company transactions are naturally eliminated in consolidated accounting and regulatory frameworks, in an aggregated framework like the BBA, some inter-company transactions could generate redundancies in capital requirements, while others could reduce the required capital of a legal entity without reducing the overall risk profile of the institution. The BBA should include a treatment

for inter-company transactions between different legal entities in the same supervised institution.

Question 18. *How should the BBA address inter-company transactions?*

Scalars. An important component of the BBA is that scalars would serve to bring jurisdictional capital frameworks to comparable levels of supervisory stringency. The BBA would need an appropriate scalar for each local regulatory capital regime, and therefore also would need a set of principles for determining those scalars. Any necessary scalars would be designed to reflect differences in supervisory purposes appropriate for insurance.

Question 19. *What criteria should be used to develop scalars for jurisdictions? What benefits or challenges are created through the use of scalars?*

Consolidation of qualifying capital. Under one version of a BBA framework, an insurance depository institution holding company or systemically important insurance company generally would determine its aggregate qualifying capital position by summing the qualifying capital position at each of its legal entities. A weakness of this approach is that it could enable the supervised institution to engage in substantial double leverage – that is, the institution’s top-tier legal entity could fund its equity investments in its subsidiaries by substantial borrowings. Such an institution could have substantial qualifying capital positions at each of its major subsidiaries (and thus a robust BBA capital ratio) but could have a weak consolidated capital position.

To address this limitation of a simple BBA, the Board is considering adopting a version of the BBA that would determine an institution’s aggregate qualifying capital position on a uniform, consolidated basis. Under such an approach, the BBA would continue to draw upon capital requirements set by the local regulators of each legal

entity, but would use a single definition of qualifying capital for supervised institutions and would apply that definition to the institution on a fully consolidated basis. To implement this version of the BBA, the Board would need to develop a definition of consolidated regulatory capital for supervised institutions significantly engaged in insurance activities, including rules to address minority interests.

Question 20. What are the costs and benefits of a uniform, consolidated definition of qualifying capital in the BBA?

Question 21. If the Board were to adopt a version of the BBA that employs a uniform, consolidated definition of qualifying capital, what criteria should the Board consider? What elements should be treated as qualifying capital under the BBA?

Question 22. Should the Board categorize qualifying capital into multiple tiers, such as the approach used in the Board's Regulation Q? If so, what factors should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the BBA?

B. Option 2: Consolidated Approach

The Board is also considering a consolidated approach (CA) to capital with risk segments and factors appropriate for supervised insurance institutions.

The CA is a proposed capital framework for supervised institutions significantly engaged in insurance activities that would categorize insurance liabilities, assets, and certain other exposures into risk segments; determine consolidated required capital by applying risk factors to the amounts in each segment; define qualifying capital for the consolidated firm; and then compare consolidated qualifying capital to consolidated required capital. Unlike the BBA, which fundamentally aggregates legal-entity-level qualifying capital and required capital, the CA would take a fully consolidated approach to qualifying capital and required capital. As distinguished from the Board's consolidated capital requirements for bank holding companies, the CA would use risk

weights and risk factors that are appropriate for the longer-term nature of most insurance liabilities.

The foundation of the CA, for systemically important insurance companies, would be consolidated financial information based on U.S. GAAP, with adjustments for regulatory purposes. Application of the CA to insurance depository institution holding companies that do not file U.S. GAAP financial statements would require the development of a consolidated approach based on SAP. Initially, the CA could be simple in design, with broad risk segmentation, but could evolve over time to have an increasingly granular segmentation approach with greater risk sensitivity. Represented as an equation, the CA could be summarized as follows:

$$\text{Capital Ratio (CA)} = \frac{\text{Qualifying Capital}}{\sum[\text{Exposure Amount}(i) \cdot \text{Risk Factor}(i)]}$$

Question 23. *What are the advantages and disadvantages of applying the CA to the businesses and risks of supervised institutions significantly engaged in insurance activities?*

Question 24. *What are the likely challenges and benefits to the development, implementation, and application of the CA? To what extent could the CA efficiently use existing records, data requirements, and systems, and to what extent would the CA require additional records, data, or systems?*

Question 25. *To what extent would the CA be prone to regulatory arbitrage?*

The CA has strengths and weaknesses as a regulatory capital framework. The key strengths of the CA include the following: (1) it has a simple and transparent factor-based design; (2) it covers all material risks of supervised institutions significantly engaged in insurance activities; (3) it is a fully consolidated framework that has the potential to reduce regulatory arbitrage opportunities and the risk of double leverage; (4) it would be relatively expeditious for the Board to develop and for institutions to implement, particularly in light of its broad risk segmentation as implemented initially; and (5) it

would provide a solid basis upon which to build consolidated supervisory stress tests of capital adequacy for institutions subject to stress testing requirements.

The key weaknesses of the CA include the following: (1) the initially simple design of the CA would result in relatively crude risk segments and thus limited risk sensitivity, and (2) substantial analysis would be needed to design a set of risk factors for all the major segments of assets and insurance liabilities of supervised institutions significantly engaged in insurance activities. In addition, a separate SAP-based version of the CA would need to be developed for the insurance depository institution holding company population if CA were ever applied to an insurance depository institution holding company that only uses SAP.

Based on the Board's initial analysis of the CA's strengths and weaknesses and comparing the CA against the considerations set forth above, it appears that the CA may be an appropriate regulatory capital framework for systemically important insurance companies. The CA, as a consolidated capital framework, would reduce the opportunity for regulatory arbitrage and the potential for double leverage. The CA also would more easily enable supervisory stress testing and other macroprudential features for systemically important insurance companies.

The advantages of the CA are most salient for systemically important insurance companies that, by definition, are large, and internally and externally complex institutions. For insurance depository institution holding companies, which generally are smaller and less complex, these benefits may be outweighed by the additional implementation costs.

Question 26. Is the CA an appropriate framework to be applied to systemically important insurance companies? What are the key challenges to applying the CA to

systemically important insurance companies? How effective would the CA be at achieving the goals of ensuring the safety and soundness of a systemically important insurance company as well as minimizing the risk of a systemically important insurance company's failure or financial distress on financial stability?

Question 27. *What should the Board consider in determining more stringent capital requirements to address systemic risk? Should these requirements be reflected through qualifying capital, required capital, or both?*

Further, the Board seeks comment on the following key issues regarding the design and implementation of the CA.

Definition of qualifying capital. Implementation of the CA would require the development of a uniform, consolidated definition of qualifying capital that is appropriate for all institutions subject to the CA.

Question 28. *What should the Board consider in developing a definition of qualifying capital under the CA? What elements should be treated as qualifying capital under the CA?*

Question 29. *For purposes of the CA, should the Board categorize qualifying capital into multiple tiers? What criteria should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the CA?*

Segmentation of exposures. Implementing the CA would require a framework for segmenting or disaggregating balance-sheet assets, balance-sheet insurance liabilities, and certain off-balance-sheet exposures. Appropriate segmentation would be important to ensure that similar risks face broadly similar capital requirements and that the capital regime produces an appropriate degree of risk sensitivity while minimizing the opportunities for regulatory arbitrage. This segmentation process would account for differences among insurance risks as well as between insurance risks and banking and other non-insurance, financial risks. While the initial version of the CA likely would have broad risk segments, the CA could evolve over time to become more risk sensitive. One option for implementing the CA for systemically important insurance companies

would be to use the segmentation framework in the Board's proposed Consolidated Financial Statements for Insurance Systemically Important Financial Institutions.¹⁹

Question 30. *What risk segmentation should be used in the CA? What criteria should the Board consider in determining the risk segments? What criteria should the Board consider in determining how granular or risk sensitive the segmentation should be?*

Question 31. *What challenges does U.S. GAAP present as a basis for segmentation in the CA?*

Question 32. *What are the pros and cons of using the risk segmentation framework in the proposed Consolidated Financial Statements for Insurance Systemically Important Financial Institutions as the basis of risk segmentation for the CA?*

Exposure amounts. The CA would need to identify the exposure amounts of the various kinds of balance-sheet assets, balance-sheet insurance liabilities, and off-balance-sheet exposures of an institution. Although in many cases, the reported amount of a particular exposure may be appropriate for purposes of the CA, in other cases the financial information of an institution may require adjustments. For example, adjusting insurance liabilities may be necessary in order to include additional, relevant information, such as current assumptions, or to better match the valuation of related assets. Further, the CA would require the determination of the appropriate exposure amounts for derivatives and other off-balance-sheet items in order to accurately reflect the risk exposure in determining required capital.

Question 33. *How should the CA reflect off-balance-sheet exposures?*

Question 34. *Under what circumstances should U.S. GAAP be used or adjusted to determine the exposure amount of insurance liabilities under the CA?*

¹⁹ 81 FR 24097 (Apr. 25, 2016).

Factors. The CA would involve a set of Board-determined factors to be applied to the exposure amounts of assets, insurance liabilities, and off-balance-sheet items in each risk segment. The factor for each risk segment would reflect the riskiness of the segment and the capital required to support that risk. Because of the different liability structures between insurance companies and banks, some of the applicable insurance risk factors may differ from the analogous risk factors that apply to banks.

Question 35. *What considerations should the Board apply in determining the various factors to be applied to the amounts in the risk segments in the CA?*

Question 36. *What challenges are there in determining risk factors for global risks?*

Minimum ratio. The CA would require the establishment of a minimum ratio of consolidated qualifying capital to consolidated factor-weighted exposures in the CA. In addition, one or more definitions of capital adequacy (e.g., “well capitalized” or “adequately capitalized”) would be needed for early remediation and other supervisory purposes.

Question 37. *What criteria should the Board consider in developing the minimum capital ratio under the CA and definitions of a “well-capitalized” or “adequately capitalized” insurance institution?*

C. Other Assessed Frameworks

In developing the two general approaches discussed here, the Board considered a number of other potential regulatory capital frameworks that did not appear to meet the Board’s supervisory objectives for supervised institutions significantly engaged in insurance activities. For example, consideration was given to applying a risk-based capital rule that is based solely on the Board’s existing capital requirements for banking organizations (Regulation Q) to supervised institutions significantly engaged in insurance

activities. Such an approach would not recognize the unique risks, regulation, and balance sheet composition of insurance firms. Although bank-like capital requirements may be appropriate for exposures that a supervised institution significantly engaged in insurance activities holds in a non-insurance subsidiary, an approach based solely on the Board's Regulation Q would not capture significant insurance risks. The Board is not aware of any major country that imposes bank capital requirements on insurance firms.

The Board also reviewed an approach that entirely excluded insurance subsidiaries and applied capital requirements only to the non-insurance parts of the supervised firm. This approach would, by definition, not capture all the material risks of the organization. While section 171 of the Dodd-Frank Act, as amended, permits the Board to exclude state and foreign regulated insurance entities in establishing minimum consolidated leverage and risk-based capital requirements, the parent holding company should be a source of capital strength to the entire entity, including to the subsidiary insurance companies and IDIs. To do this effectively, a consolidated capital requirement must take into account the risks within the consolidated organization, including insurance risks.

A capital approach based on the European Solvency II framework was considered, but would not appear to be appropriate for systemically important insurance companies and insurance depository institution holding companies in the United States.²⁰ Use of a Solvency II-based capital framework would not adequately account for U.S. GAAP and may introduce excessive volatility due to discount rate assumptions. Moreover, use of a Solvency II-based approach would involve excessive reliance on

²⁰ See Council Directive 2009/138, On the Taking-Up and Pursuit of the Business of Insurance and Reinsurance (Solvency II), 2009 O.J. (L 335) 1 (EC).

internal models. Internal models make cross-firm comparisons difficult and can lack transparency to supervisors and market participants. Additionally, such an approach would not be executable in the short-to-medium term; the notable challenges of the Solvency II regime have resulted in significantly extended implementation periods in various European jurisdictions.

The Board also analyzed a potential regulatory capital framework for supervised institutions significantly engaged in insurance activities that is based on internal stress testing. This approach would rely on internal models, be highly novel and complex, would entail a large and lengthy construction project, and would require a substantial dedication of supervisory resources to superintend. The Board intends to continue exploration of internal stress testing as it builds its supervisory stress testing program for systemically important insurance companies and its broader supervision program for supervised institutions significantly engaged in insurance activities.

Question 38. Should the Board reevaluate any of these approaches? What additional consideration, if any, should the Board give to any of the regulatory capital approaches discussed above?

III. Conclusion

The Board is seeking information on all aspects of its approaches to insurance regulatory capital and invites comment on the appropriate consolidated capital requirements for systemically important insurance companies and insurance depository institution holding companies. In addition, the Board invites comment on all of the questions set forth in this ANPR, as well as other issues that commenters may wish to raise.

In connection with this ANPR, the Board will review all comments submitted and supplementary information provided, as well as information regarding insurance regulatory capital derived from the Board's regulatory and supervisory activities. Once

the Board has completed its review, the Board anticipates that it will issue a notice of proposed rulemaking to establish a regulatory capital framework for supervised institutions significantly engaged in insurance activities.

By order of the Board of Governors of the Federal Reserve System, June 9, 2016.

Robert deV. Frierson,
Secretary of the Board.

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